

Letter of Findings: 08-0347P
Withholding Tax
For the Year 2006

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ISSUES

I. Withholding Tax – Imposition.

Authority: IC § 6-8.1-5-1(c); IC § 6-3-2-2; IC § 6-3-4-10; IC § 6-3-4-11; IC § 6-3-4-12; [45 IAC 3.1-1-7](#); [45 IAC 3.1-1-38](#); [45 IAC 3.1-1-106](#); [45 IAC 3.1-1-107](#); [45 IAC 3.1-1-108](#); *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977); *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

Taxpayer protests that it did not have an obligation to withhold income tax on behalf of its non-resident shareholders.

II. Tax Administration – First "Faulty Payment" Penalty.

Authority: IC § 6-8.1-10-5; IC § 6-8.1-10-2.1; IC § 2-5-3-1; [45 IAC 15-11-2](#).

Taxpayer protests the assessment of the penalty stating it had reasonable cause to stop payment of the check at issue.

STATEMENT OF FACTS

Taxpayer was a limited partnership based in Indiana. Taxpayer sold its partnership in January 2006 with final distributions to its members, governed by IRC § 1031, being made in July 2006.

Taxpayer filed Form DB020W-NR (Payment of Indiana Withholding Tax for Nonresident Shareholders, Partners, or Beneficiaries of Trusts and Estates) with the Indiana Department of Revenue ("Department") on March 15, 2007, the deadline for filing the form for 2006 withholding obligations. Taxpayer also initiated payment of the withholding tax by check. Taxpayer almost immediately stopped payment on the check it had sent the Department. On April 9, 2007, the Department sent Taxpayer "Notification of Returned Payment" ("Notification") stating the amount owed, which at that point also included a ten-percent penalty. The Notification stated that payment was due by April 29, 2007 otherwise Taxpayer would be subject to a penalty of 100-percent of the unpaid tax. Taxpayer did not make payment. Taxpayer filed an amended Form DB020W-NR, dated May 18, 2007, for zero withholding. Taxpayer also protested the Notification of assessment and penalty. A hearing was held on Taxpayer's protest and this Letter of Findings ensues. Additional facts will be provided as necessary.

I. Withholding Tax - Imposition.

DISCUSSION

Taxpayer protests that it did not have an obligation to withhold income tax on behalf of its non-resident shareholders.

The notice of proposed assessment is prima facie evidence that the Department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made. IC § 6-8.1-5-1(c).

In its March 22, 2008 protest letter, Taxpayer explains that it sold all of its Indiana property and stopped doing business in Indiana effective January 31, 2006 and therefore was no longer subject to any withholding obligation or other tax filing obligation as of that date.

IC § 6-3-2-2 states in part:

(a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:

- (1) *income from real or tangible personal property located in this state*;
- (2) *income from doing business in this state*;
- (3) *income from a trade or profession conducted in this state*;
- (4) *compensation for labor or services rendered within this state*; and
- (5) *income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.*

In the case of nonbusiness income described in subsection (g), only so much of such income as is allocated to this state under the provisions of subsections (h) through (k) shall be deemed to be derived from sources within Indiana. In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection (b) shall be deemed to be derived from sources within the state of Indiana [...]

(b) Except as provided in subsection (l), if business income of a corporation or a nonresident person is derived from sources within the state of Indiana and from sources without the state of Indiana, the business

income derived from sources within this state shall be determined by multiplying the business income derived from sources both within and without the state of Indiana by the following: [...]

(*Emphasis added*).

[45 IAC 3.1-1-7](#) (allocation of income among states) states in relevant part:

Allocation and Apportionment of Unearned Income for Individuals.[...]

(6) Indiana residents with income from partnerships and Subchapter S corporations are subject to Adjusted Gross Income Tax on their distributive share of partnership or corporate income. Nonresidents with income from partnerships and Subchapter S corporations doing business in the state are also subject to Adjusted Gross Income Tax on their distributive shares of income.

However, such income is apportioned to this state using the 3-factor formula outlined in [IC 6-3-2-2\(b\)](#) if the partnership or Subchapter S corporation is doing business both within and without the state. [...]

[45 IAC 3.1-1-38](#) (definition of doing business):

Doing Business. For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:

- (1) *Maintenance of an office or other place of business in the state*
- (2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods
- (3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution
- (4) Rendering services to customers in the state
- (5) *Ownership, rental or operation of a business or of property (real or personal) in the state*
- (6) Acceptance of orders in the state
- (7) *Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L. 86-272 to tax its net income.*

As stated in Regulation 6-3-2-2(b)(010) [\[45 IAC 3.1-1-37\]](#), corporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of [IC 6-3-2-2\(b\)-\(n\)](#).

(*Emphasis added*).

Taxpayer agrees that nonresidents deriving income from partnerships "doing business" in Indiana are subject to adjusted gross income tax on their distributive shares of the income of the partnership apportioned to Indiana. Taxpayer correctly cites to IC § 6-3-2-2(2), [45 IAC 3.1-1-7\(6\)](#), and [45 IAC 3.1-1-106\(b\)\(2\)](#). Taxpayer further cites to [45 IAC 3.1-1-38](#), and states:

Under this regulation, "doing business" is defined to include ownership, rental or operation of a business or property (real or personal) in the state. As of the date that [Taxpayer] sold all of its real and personal property in Indiana (January of 2006), [Taxpayer] ceased "doing business" in the state as defined in the regulations.

Based on all of the above, to which Taxpayer's own statement of that law as quoted above agrees, Taxpayer was "doing business" in Indiana. Specifically in January 2006 Taxpayer still owned property in Indiana, Taxpayer operated its business in Indiana, and when Taxpayer was sold, its sale generated Indiana source income. This is further evidenced by the fact that Taxpayer, even after registering the withholding protest, filed Indiana income tax returns on October 10, 2007, reporting Indiana source income.

Taxpayer also argues that, "Indiana lacked the requisite level of 'substantial nexus' with Taxpayer under the Commerce Clause of the United States Constitution to subject [Taxpayer] to any continuing tax filing obligation after January of 2006." Taxpayer refers to *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977); *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) for its proposition that "more than *de minimis* 'substantial nexus' between a nonresident and a state is required before a state may subject the nonresident to its taxing power." The issue, however, is not the residency of Taxpayer's nonresident members, but the residency of Taxpayer itself. It is not in question that Taxpayer was an Indiana corporation until at least the end of January 2006. Taxpayer owned property in Indiana, Taxpayer maintained a place of business in Indiana, Taxpayer's activities in Indiana exceeded the mere solicitation of orders so as to give the state nexus under P.L. 86-272, etc. There is no question that Taxpayer had nexus with Indiana.

The fact that Taxpayer's nexus with Indiana terminated sometime in 2006, does not erase its previous nexus status. If Taxpayer earned non-Indiana income after it terminated its nexus with Indiana, then the apportionment of income between Indiana and other states should be so reflected in Taxpayer's income tax returns. As a matter of fact, Taxpayer's 2006 Indiana income tax filing reflects only a 10-percent apportionment of income to Indiana.

Since Taxpayer had nexus with Indiana and received Indiana source income, Taxpayer was required to file a partnership return, IC § 6-3-4-10(a), that reflected its members' distributive shares, IC § 6-3-4-11(a). Taxpayer, pursuant to IC § 6-3-4-12 (a), was obligated to withhold income tax on the distributive shares of its members. Taxpayer was itself liable to Indiana for the tax it withheld. IC § 6-3-4-12(a)(1), IC § 6-3-4-12(c), and IC § 6-3-4-12(d).

[IC 6-3-4-12](#), referenced in the preceding paragraph, states in part:

- (a) Every partnership shall, at the time that the partnership pays or credits amounts to any of its nonresident partners on account of their distributive shares of partnership income, for a taxable year of the partnership,

deduct and retain there from the amount prescribed in the withholding instructions referred to in section 8 of this chapter. Such partnership so paying or crediting any nonresident partner:

(1) *shall be liable to the state of Indiana for the payment of the tax required to be deducted and retained under this section* and shall not be liable to such partner for the amount deducted from such payment or credit and paid over in compliance or intended compliance with this section; [...]

(c) *All money deducted and retained by the partnership, as provided in this section, shall immediately upon such deduction be the money of the state of Indiana and every partnership which deducts and retains any amount of money under the provisions of [IC 6-3](#) shall hold the same in trust for the state of Indiana and for payment thereof to the department in the manner and at the times provided in [IC 6-3](#).* Any partnership may be required to post a surety bond in such sum as the department shall determine to be appropriate to protect the state of Indiana with respect to money deducted and retained pursuant to this section.

(d) The provisions of [IC 6-8.1](#) relating to additions to tax in case of delinquency and penalties shall apply to partnerships subject to the provisions of this section, and for these purposes any amount deducted, or required to be deducted and remitted to the department under this section, *shall be considered to be the tax of the partnership, and with respect to such amount it shall be considered the taxpayer.*

(e) Amounts deducted from payments or credits to a nonresident partner during any taxable year of the partnership in accordance with the provisions of this section shall be considered to be in part payment of the tax imposed on such nonresident partner for his taxable year within or with which the partnership's taxable year ends. A return made by the partnership under subsection (b) shall be accepted by the department as evidence in favor of the nonresident partner of the amount so deducted for his distributive share.

(f) This section shall in no way relieve any nonresident partner from his obligations of filing a return or returns at the time required under [IC 6-3](#) or [IC 6-3.5](#), and any unpaid tax shall be paid at the time prescribed by section 5 of this chapter.

(g) Instead of the reporting periods required under subsection (a), the department may permit a partnership to file one (1) return and payment each year if the partnership pays or credits amounts to its nonresident partners only one (1) time each year. The return and payment are due not more than thirty (30) days after the end of the year.

(h) A partnership shall file a composite adjusted gross income tax return on behalf of all nonresident individual partners. The composite return must include each nonresident individual partner regardless of whether or not the nonresident individual partner has other Indiana source income.

(i) If a partnership does not include all nonresident partners in the composite return, the partnership is subject to the penalty imposed under [IC 6-8.1-10-2.1\(j\)](#).

(*Emphasis added*).

The Department's regulations further elaborate Taxpayer's withholding obligations.

[45 IAC 3.1-1-107](#) (partnership withholding requirements):

(a) A partnership is required to withhold income taxes at the rates provided for under [IC 6-2.1](#), [IC 6-3](#), and [IC 6-3.5](#) on any nonresident partner's distributive share of partnership income at the time the income is paid or credited to such partner as follows:

(1) For an individual partner, the adjusted gross income tax withheld shall be based on Indiana source income only, as determined by use of the apportionment formula described in [IC 6-3-2-2\(b\)](#), if applicable. This withholding requirement does not apply to withdrawals from the partner's drawing accounts, but applies to distributions to their accounts in the form of credits or payments based on anticipated profits or actual current profits.

(2) For a partner other than an individual partner, the income tax withheld may be calculated using any reasonable method designed to reflect the ultimate tax liability due Indiana because of the partnership's activities. As used in this section, "nonresident corporate partner" does not include a foreign corporation qualified to do business in Indiana.

(b) The partnership shall file a return and pay the tax on a monthly basis. The return and payment are due the thirtieth day of the month following the month for which the tax was withheld. However, if the total income taxes withheld by the partnership are less than fifty dollars (\$50) per month, the tax shall be paid and returns remitted quarterly on a calendar year basis, with payment due the last day of the month following the close of the calendar quarter. If a partnership is withholding on a monthly basis but in any month withholds less than fifty dollars (\$50), the lesser amount shall be remitted on a monthly basis to maintain the status of monthly reporting.

(c) If the partnership pays or credits amounts to its nonresident partners only one (1) time each year, it will be permitted to file one (1) return and payment each year. The return and payment are due thirty (30) days after the partnership's year end.

(d) The withholding requirements of [IC 6-3-4-12](#) do not relieve any partnership from filing its annual return, IT-65, nor do they relieve any nonresident partner from filing an annual income tax return.

(e) For individual partners only, a partnership is allowed to file a composite adjusted gross income tax return on behalf of some or all non-Indiana resident partners if the partnership complies with all of the requirements

outlined in Income Tax Information

Bulletin #72 that is in effect for the taxable year in question. An individual nonresident partner who properly elects to participate in the composite return will not be required to file an individual adjusted gross income tax return.

[45 IAC 3.1-1-108](#) (partnership withholding returns):

Partnership Withholding Returns. Partnerships required to withhold adjusted gross income tax under [IC 6-3-4-12](#) shall make returns (Form WH-1) with each payment of tax to the Department, disclosing thereon the total amounts paid or credited to nonresident partners, the tax withheld therefrom, and such other information as the Department may require. The partnership must also file an annual withholding return, Form WH-3 (including a copy of the WH-18 furnished to each nonresident) within thirty (30) days of the close of the calendar year. The partnership must furnish Form WH-18 to each nonresident partner not later than thirty (30) days from the close of the calendar year as proof that the tax upon his share of the partnership income has been withheld.

Taxpayer clearly had a withholding tax obligation on its members' distributable income.

The assessment of withholding tax against Taxpayer is not called into question. However, since Taxpayer's non-resident members made estimated tax payments throughout 2006 fulfilling their total income tax obligation to Indiana for 2006, the Department, *as a matter of policy and not law*, will waive the withholding assessment against Taxpayer.

FINDING

Taxpayer's protest that it did not have a withholding obligation is denied; however, *as a matter of policy*, the Department waives the withholding assessment against Taxpayer because Taxpayer's member partners have paid income tax on their full shares of Taxpayer's distributable shares. Taxpayer, therefore, does not owe the withholding tax assessment per the Notification it received.

II. Tax Administration – Ten-Percent "Faulty Payment" Penalty.

DISCUSSION

Taxpayer protests the assessment of the penalty stating it had reasonable cause to stop payment of the check at issue.

IC § 6-8.1-10-5 (faulty payment penalty) states:

(a) If a person makes a tax payment with a check and the department is unable to obtain payment on the check for its full face amount when the check is presented for payment through normal banking channels, a penalty of ten percent (10[percent]) of the unpaid tax or the face value of the check, whichever is smaller, is imposed.

(b) When a penalty is imposed under subsection (a), the department shall notify the person by mail that the check was not honored and that the person has ten (10) days after the date the notice is mailed to pay the tax and the penalty either in cash, by certified check, or other guaranteed payment. If the person fails to make the payment within the ten (10) day period, the penalty is increased to one hundred percent (100[percent]) multiplied by the face value of the check or the unpaid tax, whichever is smaller.

(c) If the person subject to the penalty under this section can show that there is reasonable cause for the check not being honored, the department may waive the penalty imposed under this section.

As IC § 6-8.1-10-5(c) states: "If the person subject to the penalty under this section can show that there is reasonable cause for the check not being honored, the department may waive the penalty imposed under this section."

Reasonable cause is defined in [45 IAC 15-11-2\(b\)](#) as: "Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer."

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation [45 IAC 15-11-2\(c\)](#) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed...."

Pursuant to IC § 2-5-3-1:

It is hereby declared to be the policy of the general assembly of the state of Indiana to promote a revenue raising structure in Indiana that will provide adequate revenues to carry on the efficient operation of the state, county, and city governments and at the same time will assure that its burdens will be shared equitably by all taxpayers. It is further declared to be the policy of the general assembly of the state of Indiana to encourage and bring about the accomplishment of enforcement policies and administrative practices that will result in maximum return from existing taxes to the state of Indiana at a minimum cost to the taxpayers.

In imposing the ten-percent penalty for failure to properly remit its withholding tax on non-resident members, the Department is enforcing a provision of the Indiana Code in order to ensure the continued compliance with Indiana law. The requirement to withhold on Taxpayer's non-resident members is the state's way of ensuring that the Department is provided with information it needs to carry out its objectives in the most efficient manner. The withholding requirements imposed upon Taxpayer in this instance are more efficient than the unreasonably burdensome method of the Department trying to match non-resident shareholders to their respective LLCs in order to ensure that voluntary compliance with the Indiana tax laws has occurred.

Taxpayer stopped payment on the check it had sent the Department. Taxpayer states it did so due to intervening conversations with the Department that led it to believe it did not have a withholding obligation. Taxpayer, however, admits that it was not told to stop payment on the check, but rather to follow-up with a claim for refund once payment was received by the Department. Taxpayer did not use reasonable care to follow up with the Department after it had stopped payment on the check. Since the law is clear as to Taxpayer's withholding obligations and since ignorance of the law is no excuse, Taxpayer failed to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer.

FINDING

Taxpayer's protest is respectfully denied.

CONCLUSION

This Letter notes that Taxpayer was not assessed the 100-percent "Faulty Payment" penalty.

Taxpayer had a clear withholding obligation, therefore, the Department's assessment is correct. However, as explained above, the base withholding assessment is waived (after the ten-percent penalty is calculated).

The assessment of the ten-percent penalty is not waived.

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